

CAPITAL POLICY: THE IMPACT OF SMALL BUSINESS ADMINISTRATION (SBA) LOAN PROGRAMS IN THE INNER CITY¹

SUMMARY

- SBA loan programs, which provide an alternative source of capital to small businesses, are found to disproportionately benefit inner city entrepreneurs. The higher presence of SBA loans in the inner city is not just an urban phenomenon: Even within urban areas, inner cities record a higher loan-to-firm ratio than less-distressed areas.
- However, the SBA satisfies only a very small—and shrinking—percentage of inner city loan needs. From 2006 to 2008, the percentage of inner city small business loans that were SBA-backed fell from 3.5% to 2.6%.²
- Community banks are crucial participants in SBA loan programs, accounting for only 13% of overall lending but 38% of SBA loan value.

¹ Summary developed from "Lynch, T. and Rho, L. (2011). Capital Availability in Inner Cities: What Role for Federal Policy?"

² The total inner city small business loan amounts were estimated by taking the 2006 percent of inner city employees/total U.S. employees, which is 7.4%, and applying it to the total U.S. small business loan amount.

Background

The SBA's 7(a) and 504 loan programs are designed to encourage commercial banks to lend to small businesses that might otherwise appear too risky for conventional loans. The SBA itself does not make loans. Instead, it guarantees up to 85% of the principal of loans made by commercial lenders. Between 1998 and 2007, the SBA guaranteed \$72 billion in small business loans. Lenders often resell the guaranteed portions of the loans in the secondary market.

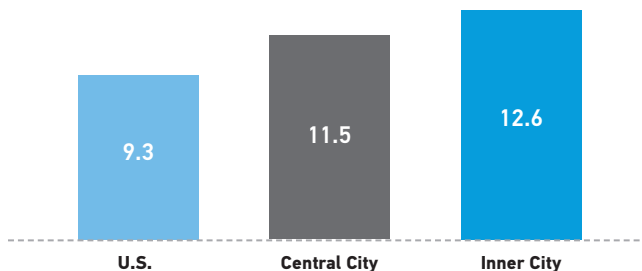
Impact Analysis

ICIC analyzed more than 530,000 SBA loans granted from 1998 to 2007. Based on zip codes, each loan was assigned to one of three geographies: the inner city, rest of center city and rest of U.S.

Inner cities receive dramatically more SBA loans than would be predicted based on the number of firms located there. The loan-to-firm ratio, or the number of SBA-backed loans granted per thousand firms, is 35% higher in the inner city than in the rest of the country. This is not just because cities get more loans: Even within cities, distressed areas get a higher proportion of SBA loans, as evidenced by the fact that the loan-to-firm ratio in the inner city is 10% higher than it is in the center city.

Between 2006 and 2008, the three years for which data is most available, the total volume of SBA loans of less than \$1 million decreased significantly, from \$9.1 billion to \$6.7 billion.³ Still, gauged by the number of businesses located there, the SBA remained more active within the inner city

AVERAGE SBA LOAN-TO-ESTABLISHMENT RATIOS, 2004-2007



Source: Small Business Administration 7A and 504 Loan data, 2004-2007, SICE, 2004-2007, ICIC analysis

³ Small business loans are defined here as those whose original amounts are \$1 million or less and were reported as either loans secured by nonfarm or nonresidential real estate or commercial and industrial loans.

⁴ Defined as banks with more than \$1 billion in assets

SBA LOANS AS PERCENT OF TOTAL SMALL BUSINESS LOANS, 2006-2008

(U.S. Millions \$)	2006	2007	2008
Total Small Business Loans	305,590	329,220	295,560
Total SBA Loans	9,060	8,900	6,690
Percent of Total	3.0%	2.7%	2.3%
Inner City Data			
Estimated Total Small Business Loans in the Inner City	22,710	24,460	21,960
Total SBA Loans in the Inner City	800	800	560
Percent of Total	3.5%	3.3%	2.6%

Source: Small Business Administration 7A and 504 Loan data, 2004-2007; FFIEC CRA National Aggregate Reports, 2006-2008 • Notes: (1) Small business loans are defined as those whose original amounts are \$1 million or less and were reported as either loans secured by nonfarm or nonresidential real estate or commercial and industrial loans. (2) The total inner city small business loan amounts were estimated by taking the 2006 percentage of inner city employees/total U.S. employees, which is 7.4%, and applying it to the total U.S. small business loan amount. (3) All SBA small business loans in this table are loans of \$1 million or less.

than outside it. In 2006, about 3.0% of all small business loans were SBA-backed, but 3.5% of inner city small business loans came with an SBA guarantee. In 2008, despite the fact that the SBA's inner city loan volume had dropped from \$800 million to \$560 million, the percentage of inner city loans that were SBA backed slid to 2.6%, compared to 2.3% in other areas.

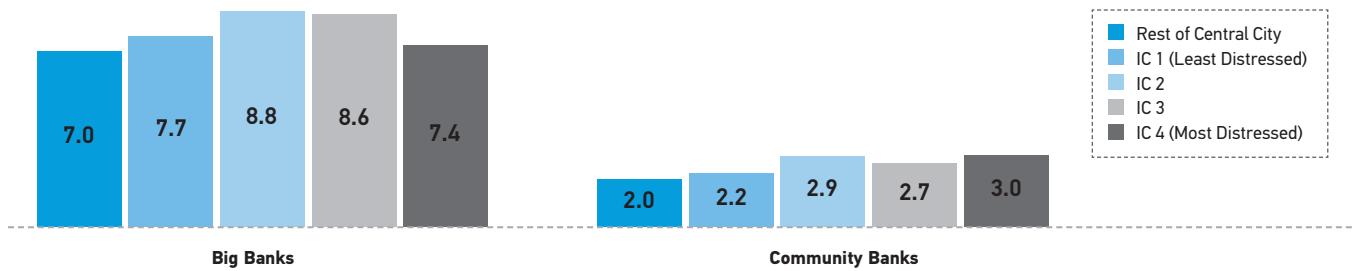
Between 2006 and 2008, the SBA's total lending to inner city businesses averaged about \$12 billion annually, at a cost to the SBA of about \$1.6 billion.

The Importance of Community Banks to SBA Lending

Because of their sheer size, large banks⁴ make more SBA-backed loans than community banks do. But community banks, given their more modest resources, do more than their share of SBA lending. Community banks account for 38% of SBA loan value, even though they make up only 13% of overall lending. In this, they are helped by their willingness to make larger loans: On average, community banks make SBA loans of about \$223,000, compared to an average SBA loan size of \$128,000 at large banks.

Unlike large bank lending, community bank lending increases with the level of a neighborhood's distress.

SBA 7A LOAN-TO-FIRM RATIOS (PER 1,000 FIRMS) BY LEVELS OF DISTRESS IN THE INNER CITY, 2005–2008



Source: Small Business Administration 7A and 504 Loan data, 2005–2008, SICE, 2005–2008, ICIC analysis

Community banks are also more likely to make loans in inner cities with declining employment than in those that are growing. These trends will intensify as large banks continue to pull out of inner cities. From 2005 to 2008, the number of big bank branches in inner cities decreased by 36%, while the number of community bank branches grew by 6%.

Limitations

Despite their success in steering credit to inner city entrepreneurs, SBA loan programs are limited by their size, sensitivity to interest rates and the strength of the secondary market for the guaranteed portion of the loans. In the aftermath of the 2008 financial crisis, issuance of SBA-backed loans dropped by 40% and did not begin to rebound until a provision in the 2009 Recovery Act increased the guaranteed portion of 7(a) loans to 90% and eliminated many fees.

Recommendations

The SBA plays an outsized role in the funding of inner city businesses, giving these neighborhoods—and the entrepreneurs doing business there—opportunities they might otherwise have missed. It is likely that community banks, already crucial supporters of the SBA program, will become even more important to its success as large banks leave

distressed areas. Given the importance of the program to inner city entrepreneurs—and the significant leverage achieved by the SBA—we see a clear argument for the expansion of SBA lending, particularly through greater participation of community banks as SBA lenders.

While it is clear that SBA loans are successfully increasing access to credit in distressed urban areas, it is difficult to interpret the exact reason for the higher prevalence of SBA loans in inner cities without loan default rates and credit profiles of businesses by geography. Given the previous observations of the weak and further-declining presence of traditional sources of capital in the inner cities, combined with the fact that—due to fixed interest rate caps and fees—SBA-backed loans tend to be more expensive for entrepreneurs than conventional loans, a higher proportion of SBA-backed loans in a given area could point to signs of weakness and inefficiencies in the local capital markets.

ICIC'S MISSION IS TO DRIVE ECONOMIC PROSPERITY IN AMERICA'S INNER CITIES THROUGH PRIVATE SECTOR INVESTMENT TO CREATE JOBS, INCOME AND WEALTH FOR LOCAL RESIDENTS.



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Initiative for a Competitive Inner City

200 High Street, Third Floor ■ Boston, MA 02110 ■ www.icic.org ■ [twitter:@icic.org](https://twitter.com/icic.org)